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A Business Unit of Unocal

April 25, 1997



Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
Building 85, Denver Federal Center
Denver, CO 80225

RE: Establishing Oil Value or Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil - 62 Fed. Reg. 3741 (January 24, 1997)

Dear Mr. Guzy:

Spirit Energy 76, a business unit of Union Oil Company of California d/b/a Unocal, hereby submits its comments to the MMS proposed rulemaking governing oil valuation for federal leases.

GENERAL OVERVIEW OF PROPOSED RULES

In general, Spirit Energy 76 ("Spirit") does not believe that the MMS' proposed eliminated reliance on posted prices adds more certainty to the valuation of crude oil. The formula set forth by the MMS is extremely complex for the determination of royalty value. The formula is also flawed thereby rendering it completely unusable.

Moreover, the proposed rules deviate from the MMS' long history of determining value at or near the lease. By defining market value as the NYMEX futures price for West Texas Intermediate crude oil at Cushing, Oklahoma, the MMS ignores the competitive market for crude oil at or near the lease. In addition, the MMS has decided that arm's length contracts are no longer valid for royalty determination purposes which is a significant deviation from the MMS' past practices.

SECTION 206.101

Spirit opposes the deletion of the definition of "Marketing Affiliate" because of the numerous administrative and legal actions concerning the affiliate issue.

As proposed the definition of "Gross Proceeds" reads, in part, as follows: "Gross proceeds include payments for services such as dehydration, measurement, and/or gathering which the lessee must perform at . . ." Spirit believes the word "must" should be more neutral. As worded, there may never be a situation where the costs of the listed services would be deductible.

The term "index pricing" includes a requirement of using NYMEX futures prices or Alaska North Slope (ANS) crude oil spot prices for royalty valuation. Spirit would like to see more generic language used thereby allowing for future flexibility.

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SECTION 206.102(a)(3)(ii)

Spirit believes that the requirement of justifying value to the MMS' satisfaction is too discretionary. There should be some criteria or examples to base the MMS' decision upon.

SECTION 206.102(a)(6)

As written, even if Spirit enters into an arm's length contract for the sale of its oil, it must value its oil under paragraph (c)(2), if Spirit or its affiliate purchased crude oil from an unaffiliated third party in the two-year period preceding the production month. Spirit believes this requirement is too broad as it virtually eliminates all arm's length contracts as a basis for royalty valuation, in spite of the fact that arm's length contracts have always been an acceptable method for royalty valuation.

SECTION 206.102(c)(2)(i) and (ii)

Spirit does not agree with the valuation method set forth when value cannot be determined under the gross proceeds method because the proposed methodology ignores the highly competitive, very active lease market that exists. We also do not believe that this methodology is in accordance with the lease terms and it appears to be inherently unfair to the lessee.

SECTION 206.102(e)

Spirit does not agree with the language contained in this paragraph which requires the Lessee to market the oil at no cost to the Federal Government unless otherwise provided in the lease agreement or the regulation as it could be interpreted as requiring Spirit to market downstream of the lease. Spirit does not believe that the lease obligates it to perform marketing downstream of the lease. Spirit believes that the MMS is taking the lessee's obligation to place oil in marketable condition and trying to expand on that obligation thereby requiring the lessee to market at no cost. Accordingly, Spirit would recommend that the words "at the lease" be added after the word "lessor" and the words "at no cost to the Federal Government" be removed.

SECTION 206.102(e)(2)

Spirit does not understand the sentence: "if you are entitled to a credit, MMS will provide instructions for taking that credit." Pursuant to the Federal Oil and Gas Royalty Simplification and Fairness Act, the lessee and/or its designee is allowed to recoup overpaid royalties. Accordingly, we do not understand the intent of this sentence.

SECTION 206.157(f)

Spirit believes the phrase "May I ask MMS to determine a value?" should be revised to read "May I propose an alternative valuation method?" As proposed the rules already provided for a determination of value in other sections.

SECTION 206.102(g)

Spirit disagrees with the portion of this section which states "...closing of the audit period does not foreclose MMS from correcting the error and collecting any royalties due." Pursuant to the Federal Oil and Gas Royalty Simplification and Fairness Act, Spirit believes the closing of the audit period does foreclose the MMS from collection of any royalties due.

SECTION 206.103

Although MMS states that this section has not been revised paragraph (a)(1) of this section states "royalties shall be computed on the quantity and quality of oil as measured at the point of settlement approved by BLM or MMS for onshore and offshore leases, respectively." Although the MMS has defined a number of location and quality differentials, they all stop at an aggregation point. Further, the proposed rule does not allow for a gravity adjustment between the point of settlement and the aggregation point.

SECTION 206.104(c)

Spirit requests clarification of whether the 50% limitation is determined at an aggregation point before or after the differential.

SECTION 206.105(c)(i)

As proposed, Spirit does not believe the location and quality differentials are proper. The proposed rule provides for NYMEX value adjustment using the published spot market price at a market center. As we understand it, spot market prices represent a price that a refiner was willing to pay to fill a small portion of its refinery capacity. Accordingly, there is no allowance for a location difference between Cushing, Oklahoma and the respective market center as defined by MMS.

SECTION 206.105(c)(ii)

Spirit believes that the location/quality difference can only be used if the exchange agreement specifies the lease the oil is deemed to come from. Otherwise, it is impossible to trace crude oil. Thus, in the event a lessee has an expressed differential, he will not know to what lease it should apply. In addition, a differential and an exchange agreement is a trading difference and it is not intended to define cost between an aggregation point and a market center. Spirit also believes that it might be possible for a lessee to have an exchange agreement between an aggregation point and a market center in which there is no differential. As such, Spirit does not believe that the use of differentials stated in exchange agreements is proper.

The MMS has not explained how it will calculate the location/quality differentials. The MMS will have to address how to calculate a weighted-average differential in various situations. Although this may assist the MMS in the statistical accuracy of their computation, it will not improve the age of the data. There are several flaws with the proposed data collection methodology in the proposed rule and the preamble that would cause duplicate reporting and misrepresentative data.

Duplicate reporting can occur, through no fault of the reporting party, when both parties are federal payees and are both reporting the transaction, each from their respective points as payors. The fact that the transaction may be tied to a federal lease for one payor and to a private lease for another may cause the MMS to overlook the duplication. MMS oversight as to duplication may also be caused by differences in terminology regarding the identification of aggregation points.

With regard to misrepresentative data, the preamble to the proposed rule states that "Reporting duplicate information would not be required (e.g. identical location/quality differential between the same point)." 62 FR 3749. This directive could cause misrepresentative data to be used since there may be three separate high volume sales with identical location/quality differentials between the same point with a requirement that only one sale be reported. The only other sale at the same point may be for very low volumes at a radically different price. If the volumes are not taken into account, the location/quality differential calculated by the MMS could statistically misrepresent the differential.

Spirit reiterates its concern that the reliability of this published location/quality differential is a key concern. Much of the data collected will not be useful for the calculation of the location/quality differential between MMS-identified aggregation points and market centers. 62 FR 3754 (proposed Section 206.105(c)(i)(iii)). Only reported transactions between aggregation points and market centers will provide MMS with the data needed for the MMS-published location/quality differential. Transactions occurring between a lease and an aggregation point and sales at index pricing points would be of no relevance to the MMS-calculated differential. Lessees would spend significant money and time completing reports on such transactions that would be irrelevant to the MMS' stated purpose--publication of differentials for each aggregation point and associated market center. 62FR3747.

Spirit objects to the proposed data collection requirement as it will impose a significant day-to-day cost of complying without providing statistically accurate or verifiable data.

CONCLUSION

Spirit strongly urges the MMS to withdraw the proposed rule. As proposed, Spirit and other industry companies will be required to expend thousands of man-hours in order to comply with the rule and prepare the form MMS-4415. Moreover, this would require the expenditure of millions of dollars to modify systems in order to capture the requisite data for reporting purposes. Lastly, Spirit believes that the proposed rule ignores the lease market concept which Spirit believes is the appropriate market for determining royalty value.

8. Crude Quality - Form MMS-4415 also requires sulfur content data for each transaction. The specific sulfur content is not usually kept at the sales transaction level. Although the producer may know the sulfur content of each lease, the production can be commingled or aggregated with various types to provide a specific type of crude under a contract. To know the sulfur content at the title transfer point or "Market Center" may require an additional sulfur measurement (at an additional cost).

The MMS has estimated the reporting cost imposed by the rule to be \$800,000 per year to industry. 62 FR 3750. This estimate is based on the assumption that on average, a payor would have 64 agreements from which data would need to be extracted. The MMS estimated that it would take 15 minutes to gather the information needed to complete Form MMS-4415 and that the labor costs to comply with the collection obligation would amount to \$25.00 per hour.

Spirit believes that the MMS' estimate is unrealistically low. Because the requirement is not limited to Federal oil, a Federal lessee must complete Form MMS-4415 on every exchange or buy-sell agreement for all crude oil production whether Federal, Indian, State or private. For many payors, collecting such data would greatly exceed 64 agreements. It is also disproportionate to the amount of Federal interest a lessee may have leased.

Spirit also believes that the 15-minute estimate is low as it is evident that the time necessary to complete MMS-4415 will greatly exceed fifteen minutes. As explained above, the information is not easily obtained. Moreover, it is important to note that there will be significant startup costs for the initial data collection and systems modifications or development to collect data that is either not centrally located or currently not collected in a database.

The reporting burden in the preamble states "All Federal and Indian lessees (or their affiliates as appropriate) would initially submit Form MMS-4415..." 62 FR 3749. However, as proposed this could create a burden for a company with only Indian royalties which are not subject to this valuation method.

Spirit does not believe that the MMS has explained or supported its need for data on transactions which do not occur between market centers and aggregation points. A Federal lessee should not be burdened with reporting all transactions, whether Federal, State, or private, regardless of where the transaction occurs (lease, aggregation point, etc.) especially since the usefulness of the data is in question. In addition to requiring industry to expend time and money reporting each transaction, the MMS will also have to develop a labor intensive and costly system to review and analyze the data.

VALIDITY OF STATISTICAL DATA

Spirit believes that the information being collected on Form MMS-4415 will provide the MMS with information that will be so diverse and sometimes duplicative that the accuracy of the subsequent location/quality differentials will be in question. The proposed rule provides for the privacy of the information, thus, the concern about accuracy is magnified since there will be no way for industry to confirm the calculations.

representative market center-aggregation point location differentials in the Federal Register by the effective date of the rule.” Given the issues outlined in this section, Spirit doubts there will be sufficient time to report by the first deadline.

3. Contract Party Name - This item would require the contract party name and MMS Payor Code (if available). Spirit believes that obtaining the Payor Code would be burdensome.

4. Contract Type and I.D. - The guidelines accompanying the form in Exhibit A (62FR3758) state “Also, fill in the Contract Number that would allow a third party to clearly identify the document.” The Contract Number has not been defined. Nor is it clear whether the number assigned to the contract should be the internal company number or whether that number would be sufficient to “allow a third party to clearly identify the document.” Moreover, use of both your contract number and the other company’s internal contract number is an additional burden since their contract number is usually not readily available.

5. Contract Term - An end date is not always available on month to month contracts. Thus, how will the MMS know when the contract expires? Will they try to apply the contract for valuation purposes for too short or too long a time period? How will they know when a new contract is entered into for the same mineral lease and that this contract is in effect terminated?

In addition, how will we determine when a new report is required. One lease, as mentioned, may be included in a contract one month and not the next. It is clear that requiring a report each time the contract changes, would certainly provide the most accurate data; however, it will also increase the reporting burden estimated by the MMS and the time required for the MMS to compile the data.

6. Title Transfer Location - The instructions for identifying the title transfer location appear to require transportation costs in segments if production travels through more than one aggregation point. These costs are not accounted for in this manner, to do so would require a significant effort on a recurring basis. By not allowing FERC tariffs to be used by a company or company affiliate transporting the company’s product, new reports and systems calculating actual costs would have to be developed.

Requiring the MMS lease number or lease numbers further complicates the reporting as there could be different transportation arrangements when different leases are included. Varying leases may even be included in the arrangement from month to month for the same contract

7. Volume Terms - In the instructions for completing MMS-4415, the reporter is advised to “not include production subject to call rights where another party has the right to purchase oil at some redefined price basis or to match other purchaser offers.” 62 FR 3758. Determining that a call exists would require an expensive title review of both public records and private records since the crude oil call may not have been exercised.

SPIRIT'S COMMENTS TO FORM MMS-4415

Spirit believes that the proposed rule imposes a new and onerous reporting obligation on federal lessees and/or payors. The Oil Location Differential Report, Form MMS-4415, must be filed by all Federal Lessees for all crude oil production sold, regardless of whether from Federal, Indian, State, or private lands. See. 62 FR 3755 (Proposed Section 206.105(d). Although, the current reporting obligations remain in place, Form 4415 creates new and additional burdens.

The rule proposes that this form would:

capture location differentials in all exchange agreements or other oil disposal contracts. MMS would use these [sic] data to calculate location differentials between market centers and aggregation points. 62FR3749

As proposed, Spirit believes the reporting requirement has numerous problems. These problems include, but are not limited to, the ambiguities of the form, the immense burden associated with collecting and using the data requested, and the lack of viability of the data once collected. The purpose of this section is to address the aforementioned shortcomings.

AMBIGUITIES OF FORM REQUIREMENTS

1. **Payor Information** - Spirit believes that there is confusion over who should submit Form MMS-4415. The requirements of the proposed regulation state that:

You must submit information on Form MMS-4415 related to all your and your affiliates' crude oil production, and not just information related to Federal lease production. All Federal lessees (or their affiliates, as appropriate) must initially submit Form MMS 4415 no later than 2 months after the effective date of this reporting requirement, and then by October 31 of the year this regulation takes effect and by October 31 of each succeeding year.

However, the form guidelines in Exhibit A of the proposed rule provide that the payor complete the form. The guidelines do not indicate who should complete the form when the payor is not the lessee.

Also, if only the lessee is required to report, they may have insufficient data to complete the report. Similarly, the payor may have insufficient information to complete all the requirements of the form. If a payor and lessee are different and the payor reports on a lessee's transaction, should the payor number of the payor or the lessee be used for reporting purposes? Clarification about who should report is just one area that must be addressed by the MMS.

2. **Due Dates for Information** With respect to the "Frequency and timing of submittal, frequency and timing of MMS's calculation...", Spirit believes that the data being collected lends itself to many questions. Further, the data represents dated information that could not predictably reflect a current market. Spirit suggests early submittal as an option (62FR3749) in order to allow the MMS to "publish

SECTION 206.105(c)(iii)

In addition to the reasons contained in Section 206.105 (c)(ii) above, Spirit has the following additional concerns with regard to this section. As proposed, the MMS plans to gather data for the past year and to publish differentials for the current year based upon the data gathered. However, it is obvious that this method fails to recognize changing market conditions, as it assumes that market conditions existing in the past are the same as those that exist currently. Spirit also has a concern with regard to how the MMS will interpret the data and how the industry will be able to determine whether what the MMS has published is correct.

SECTION 206.105(c)(iv)

Spirit believes that it will be difficult to determine the actual cost of transportation from the aggregation point to the lease especially in situations when Spirit is selling its oil at the sales meter. If the oil is being moved to the aggregation point, it will be extremely burdensome in order to determine the actual cost in moving the oil because these costs have not been tracked in this manner.

SECTION 206.105(c)(4)(iii)

Spirit believes the penalty proposed is extremely harsh and is similar to the allowance pay-back penalty. Due to changing conditions and new lease development, it will be difficult for Spirit to know when it needs the MMS to calculate a differential. Furthermore, the Federal Oil and Gas Royalty Simplification and Fairness Act defines the refunding of other payments as an obligation of the Secretary.

SECTION 206.105(b)(5)

Spirit is also opposed to deleting Section 206.105(b)(5). Spirit bases its opposition on the Transportation Allowance Exceptions decision of Lucy R. Querques, Associate Director for Policy and Management Improvement, in the appeal of MMS-94-0675-OCS; MMS-95-0049-OCS; MMS-95-0352-OCS; MMS-96-0138-OCS; and MMS-96-0357-OCS.

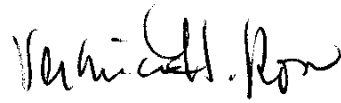
INTERIM FINAL RULE

Spirit objects to the MMS' proposal of issuing an Interim Final Rule rather than a Final Rule due to the significant compliance costs involved in these two implementation processes. Spirit would incur considerable costs if the MMS were to make further changes to the Interim Final Rule after Spirit has made internal adjustments to comply with the same. Furthermore, based on the various issues which require further clarification, Spirit believes that it would be premature to issue either an Interim or Final Rule at this time.

Mr. David S. Guzy
Chief, Rules and Procedures Staff
4/25/97
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Thank you for the opportunity to respond to the proposed rule.

Sincerely,

A handwritten signature in black ink, appearing to read "Veronica H. Roa". The signature is fluid and cursive, with the first name "Veronica" being more prominent and the last name "Roa" following in a similar style.

Veronica H. Roa
Attorney